THE SPECIE RESERVE IN A BANKING SYSTEM[1]

By the term "reserve" of a bank, as generally used in this country, we mean the amount of cash kept on hand to pay obligations to depositors and note-holders when these obligations are demanded in the form of money. The word "reserve" is a somewhat unfortunate term in this connection, for it tends to strengthen the common notion that the business of a bank is to receive money by deposit from some people and to loan out part of it to others, keeping back, or reserving, some for emergencies; whereas deposits are often not in the form of money, and a bank would have to pay out cash on demand to discharge its obligations, whether its depositors ever left it any money or not. For it is a well-known fact that the bulk of our bank deposits consists of book credits based upon notes discounted, and not upon a deposit of money.

Most of the payments demanded of a bank are called for not in the form of money, but of cancellation of book indebtedness, or transfer of some of its obligations from one creditor to another. It is possible, though hardly likely to occur in practice, that the aggregate liabilities of a bank might not change in the course of a day's business, and yet that the items comprising that aggregate liability might show many transfers and changes of the bank's indebtedness. In the process there might be no call for money.

The term "reserve" fixes attention upon that part of the bank's assets which consist of cash. Under some conditions, however, the solvency or safety of a bank depends as much upon the character of the other securities it holds as upon its amount of cash in hand. There are second and third lines of reserve. If these securities are not readily salable for money when the bank needs it, the actual amount of its money reserve may not avail against disaster. Indeed, if the importance attached to the cash reserve in the minds of many people were justified, a bank should logically be required to keep an amount of cash equal to its total liabilities to

[1] A paper read before the Western Economic Society, at Chicago, November 11, 1911.

depositors and note-holders; in which case it could not do any business, or at any rate, make any profit.

However, without drawing any distinctions that are too fine, we may accept the view that the reserve is the amount of acceptable money which a bank keeps on hand to pay such of its obligations as must be made in cash.

A reserve must be kept against deposits and against notes, if these are issued on commercial assets, as they should be. In our system there are no true bank notes. Our national bank notes are indirect government issues. Against them, under our law, no reserve need be kept. If they should be replaced or supplemented with real bank notes, a reserve would have to be provided.

The kind of money in which the reserve must be kept depends mainly upon the character of the business done by the bank, and its location. The reserve for ordinary domestic needs is one thing. That needed as a basis for foreign payments is quite another. The reserve, whether against deposits or notes issued, or both, must be kept in that kind of money which the customers of the bank need. For home use, it may properly consist of any form of money which the people are accustomed and willing to use. Notes will answer this purpose as well as specie. Banks which do an exclusively home business do not need gold, which is the only form of money acceptable in the international market. A currency reserve is sufficient for them. This is true whether the currency be issued by the government or by some central or federated institution, such as is suggested in the Monetary Commission plan. If we should establish such a bank, or Reserve Association, its notes could very properly be used as a reserve by banks in the interior part of the country, although they could not be so regarded for the central or federated bank itself. The Reserve Association, or the government, if the notes were issued by the government, would be obliged to keep a reserve of specie for their current redemption. The interior banks need not.

In the last analysis, all credits must rest upon an adequate basis of gold. If the interior banks keep their own reserves they must keep them in gold or its immediate equivalent. At present that immediate equivalent, so far as it consists of notes, is United

States legal-tender notes, which are exchangeable for gold at a subtreasury. Therefore the subtreasury must have the gold. If the interior banks are to be permitted to keep their reserves in the notes of a central institution, like the proposed Reserve Association, that association must have the gold necessary to redeem the notes on demand, in addition to the amount necessary to meet specie demands for its deposits.

The need for specie arises also from the necessity that foreign payments must be made in gold. This need of keeping a specie reserve to meet foreign obligations, the payment of foreign balances, must be kept in mind in every banking system and by every bank that issues notes redeemable in gold. It is the duty of banks which do this sort of business always to have on hand specie enough to meet the requirements of the situation.

The two needs for a specie reserve, then, are as a basis of issue and redemption of home obligations, and as a basis of foreign payments. The needs must be recognized and provided for by all banks, especially at times when their obligations run beyond the usual amount, and more particularly, if payment of any part of their obligations is likely to be called for in a form that will satisfy a foreign creditor. Gold must be available somewhere in the system. It must be held by the individual banks, or in sufficient amount by a reserve or central institution.

This necessity brings us to the question of the relative advantages of what is known as a single-reserve system as compared with those of a multiple-reserve system.

By a one-reserve banking system we mean a system wherein one great bank is the depositary of the specie of the country, and is looked to to maintain a specie reserve sufficient to satisfy both domestic and foreign needs. Under this system all the other banks of the country pay little if any attention to the maintenance of a specie reserve. They deposit their balances in the one great institution, and rely upon getting money in any form they need by drawing on their accounts in that institution. The best-known instance of this kind is the English system. The Bank of England is looked to by the other English bankers to protect the specie balance of the country, and these bankers pay little

attention to keeping gold in their own vaults. We ourselves approximate the one-reserve system in a half-hearted way in that provision of our national banking law which permits country banks to keep part of their reserve in reserve cities. Under this law banks in central-reserve cities are required to keep a reserve of 25 per cent in legal money against their deposits. Banks in other cities are required to keep 15 per cent of their deposits in the form of legal money in reserve. But three-fifths of this 15 per cent they are allowed to deposit in the central-reserve banks and count as reserve. That is, they send part of their required reserve to the central-reserve banks to be kept as reserve. As a matter of fact, only one-fourth of it need be kept on hand there. For example: if an interior bank had deposits of $200,000, it must provide a reserve in lawful money of $30,000. It may keep $12,000 and deposit $18,000 in its reserve banks. These need retain only the required one-fourth, or $4,500. Thus the lawful money reserve actually in hand is $16,500 and not $30,000.

In the past the state banks and trust companies often have kept small reserves of cash, relying upon the national banks through which they carry their balances. Therefore the task of carrying the reserve for all banks has been largely put upon the national banks of the reserve cities. These carry not only their own burden in the matter of reserve but the burden of competitors organized under state laws, and the burden of the smaller national banks. Our system therefore approaches the one-reserve system in the sense that it reduces to a minimum the number of banks upon which is placed responsibility for maintaining the specie and legal-tender reserve of the country.

The multiple-reserve system is that in which each bank keeps its own reserve of lawful money and specie. In theory this is the system on which we have organized our national banks. In practice, however, as we have just seen, we do not adhere to it.

The one-specie-reserve system, especially as it exists in England, is, of course, subject to all the dangers that come from a highly centralized system. It has been frequently said in recent years that the specie reserve kept by the Bank of England is inadequate for the growing business of the country, and that danger of collapse

at some critical moment is greater than it used to be. The one-reserve system requires more careful and prudent management by the bank that keeps the reserve. On the other hand it is economical of the country's capital. Less needs to be invested in gold. For a smaller reserve is needed, if centralized, than if distributed among many banks, because the process of cancellation of indebtedness can be carried farther. In other words, a larger volume of credit can be based upon a given amount of gold. This is the strength, if, as is claimed, it is also the weakness, of the English situation. Moreover, a great central reserve of specie is visible to all the world, and inspires a confidence that scattered reserves do not. That these advantages of a central specie reserve are appreciated even under our present system is shown by the fact that in every important monetary stringency in this country in recent years the associated, or clearing-house, banks of New York City and other places have pooled their reserves. The result in each case has been to give these the power of one great reserve. The action economized the available gold and inspired confidence.

The advantages of a central-specie-reserve system are greater in a country with so many banks as our own, for the reason that foreign settlements are conducted through only a few centers—indeed, practically through only one, New York. As has been remarked already, the business of the rest of the banks is such that settlements may be made easily enough in other money than specie. On the whole, therefore, the balance of argument seems to be in favor of keeping the specie reserve of this country in one great institution, which should be located in the place which is the center of foreign settlements, as well as of domestic exchanges.

If we adopt the policy of a one-specie-reserve system, the question arises: What form of banking organization should care for it? If we abandon the plan of requiring each bank to keep its specie reserve either wholly or in part, and adopt the plan of a central reserve, shall its maintenance be made the duty of a central bank organized in the ordinary way or shall the reserve be kept by the government?

Opinion in this country is likely to be long divided on the question of the comparative advantage of having the government keep

the specie reserve of the country or having it kept by central institutions under private management. Certain it is that there is a profound and widespread distrust of the banking and financial interests of the country with reference to their inclination or ability to manage a currency system in the interests of the people. On the other hand, business men shrink from subjecting so delicate a part of our commercial machinery to political influences and their possible domination. In the Bank of England we have a magnificent illustration of a case where the public monetary interests are well managed and conserved by a private corporation. This was not always true. The duty has been recognized by the Bank of England for not more than a generation. Previously, the bank's sense of duty in this matter was as low as that attributed to our bank managers. The responsibility was tacitly assumed only after a long period of trouble had shown its necessity and public opinion had strengthened the feeling of public duty on the part of bankers. Both of these conditions are now realized in this country by a few bankers. But the number is not large among those in positions of great influence, and the people do not seem ready to trust bankers with the power necessary to the proper discharge of this duty. We are not ready to admit that our bankers and business men are less able than their English brethren to do this work. But they have not done it and the people hesitate to believe that they will do it if the task is given them. What are the reasons for this feeling?

Undoubtedly the principal cause of the distrust felt by the people of the financial world is born of the evils that have come from the confusion of our commercial and financial banking. Our banks, even those which were intended to be purely commercial, have been too commonly used for the promotion of financial enterprises by those who ought to have kept business credit in liquid form. In other words, instead of being treated as an agency of commerce, the banks have been used as a means for promoting industrial and transportation interests. They have come largely into the control or under the domination of so-called "financial magnates," and have become identified in the minds of the people with the industrial and transportation enterprises promoted by these magnates. This is true of national as well as of state and private

banks and trust companies. The primary function of the commercial bank has been almost lost sight of. The people have come to think of the banks of New York as the Standard Oil group and the Morgan group, and they know very well that the power of these groups of banks is not confined to New York City. For this reason it is difficult to persuade many people that it would be advisable to make arrangements which would make it possible for either or both of these interests to come into greater control of our money system. In order to reassure the popular mind we must find some means of organizing our banking system so as to separate its commercial machinery from financial and industrial promotion, and so make it impossible for any one or any group to use the machinery of commerce for speculative profit.

If we turn to the possibility of a reserve managed by the government, there is much to be said in its favor on the side of freedom from financial and speculative domination. On the other hand, we must remember that government officers may be the creatures of party politics, and it is conceivable that with a purely government institution holding the specie reserve of the country, political influences would play a greater part than they should. Moreover, it is idle to suppose that the managers of a government bank would necessarily be free from the dictation, or at least strong influence, of the financial promoting groups that have so long dominated our currency situation. It has been openly charged that one secretary of the treasury once gave special advantages to one of the great banking interests of New York City mentioned above. Moreover, in every crisis the secretary has been obliged to consult the representatives of these interests and has been largely influenced by their views concerning the proper monetary policy of the Treasury under existing circumstances. Any other course would have been impracticable. To put the management of the reserve in the hands of government officers does not remove it from such influences as have been mentioned and subjects it to the additional danger of politics. We are beginning to forget the experiences of the decade from 1886 to 1896.

With such strong reasons against an organization subject to financial influence on the one hand, or to political influence on the

other, we seem to be in the dilemma of finding it impossible to have either a privately managed or a publicly managed institution with entire safety. There are certain considerations, however, that point the way of escape. In the first place, whatever criticism may be made of the use of our banks by financial and industrial promoters, there is no doubt that the country today has men, bankers and merchants, with the spirit of the governors of the Bank of England, who in such an office as director or manager of a new bank for the management of the currency would discharge their duties with an eye solely to the public interest. I have a belief that the time has come in our economic and social progress when the sense of public responsibility in such matters has become strong enough to justify us in expecting to find such men.

On the other hand, there is no doubt that if such men were found and put in charge of an organization with such great powers as will necessarily be intrusted to a bank that manages the specie reserve of the country, they would be subjected constantly to pressure from private interests on the one hand, and political interests on the other. They should be protected as far as possible, therefore, through government supervision by federal administrative officers appointed irrespective of politics, and with a tenure of office that would make them independent of the vicissitudes of political fortune. We in this country do not make a sufficiently sharp distinction between our administrative officers and our politicians. It is the latter, using the term in the ordinary sense, that we need to fear in connection with the currency system.

The way out of the difficulty lies, therefore, in the establishment of a privately owned institution with government supervision, or part government ownership; and to the writer it seems that the plan proposed by the Monetary Commission for a federated or central reserve association, whose owners shall be the banks of the country, with proper government supervision, is a good solution of the problem.

Having determined that a central institution of some kind is the best agent for holding and managing the specie reserve of the country, we must inquire next into the principles of management: how the specie is to be obtained and held. There is a common

feeling in this country that the law should prescribe the minimum reserve which a bank must hold against deposits. Very little can be said in defense of a legal minimum requirement, especially for a great single institution that is the core of the bank system. As has been pointed out, the minimum reserve prescribed by law today for our national banks is actually not maintained because of the growth of banks not subject to the law. According to the abstract of the report of the condition of national banks made by the Comptroller of the Currency on September 29, 1911, the demand liabilities of the national banks alone, omitting liabilities of one national bank to another, aggregated more than seven thousand millions of dollars. On the same date the aggregate amount of lawful money held by the banks was, in round numbers, 930 millions of dollars. This is about 13 per cent of the demand liabilities. If we omit national bank notes from the liabilities, the percentage of lawful money reserve becomes 14. On the same date the national banks owed state banks a little more than 500 millions of dollars, and trust companies and savings banks more than 546 millions. If 400 millions of the latter sum belonged to the trust companies alone, we have an aggregate of 900 millions due from the national banks to their rivals. In other words, the lawful money resources of the national banks on the day in question were just about equal to the demand deposits of banks other than national. It is very clear that the requirement of a legal minimum reserve by the national banks does not provide an actual reserve of anything like that amount against all the bank deposits of the country.

In the second place, a minimum reserve requirement is a danger signal for the public. When the banks begin to approach it, people become alarmed and do things which strengthen the influences that are the distress in the reserve.

In the third place, such a provision is ineffective. A reserve in any proper sense of the term is a store of money to be used when sorely needed. If the law requires the banks to hold a certain amount of money under all conditions, it cannot be used when it is needed.

In the fourth place, the requirement of a minimum reserve

induces carelessness and overconfidence on the part of bankers. They are inclined to think that if they comply with the law they have done all they should.

A bank's reserve and its ratio to the bank's deposit liabilities are the barometers of its management. To hold too great a proportion of gold restricts profit; to hold too small a proportion invites ruin. Good banking depends not on good laws but on the exercise of good judgment by good bankers. It is probably too much to hope for in the present state of public opinion in this country, but the best results would doubtless be obtained if the proposed "federated bank of banks" or National Reserve Association, should be allowed to manage its own specie reserve against deposits under the careful scrutiny of competent managers, and a board of government supervisors, without reference to any legal minimum. The necessities of trade will require it to keep a large amount of gold, for we need a repository of gold from which we can get the metal for foreign drain and to maintain the proper reserve against the domestic liabilities of the federated bank, whether these liabilities are deposits or note issues.

In my opinion, the case is somewhat different with a reserve against note issues, under the conditions which prevail in our country. A certain amount of specie reserve should be required to be constantly on hand for current redemption of notes. For the notes of every bank should be sent home for redemption as fast as other banks get hold of them. This is the means whereby elasticity is established and maintained. When currency becomes redundant, it should be redeemed in the form in which it can be sent from the country. That form is gold. For these reasons it seems to me that so far as concerns a reserve against notes the latest suggestions of Senator Aldrich have good foundation, although as printed they are inconsistent with each other. I do not believe we should prescribe these reserve conditions for deposit liabilities.

The *ultimate* banking reserve of the country must be in gold. It must be adequate and it must be subject to ebb and flow. It must be an influx and efflux of specie due to the same operations for which notes are issued and discounts are made. It is important to inquire how such a reserve is obtained and maintained.

There are two ways of maintaining a specie reserve. One is to accumulate the gold and hold it; the other is to be able to get it when you want it. Under the first system the country must put what restrictions it can against the exportation of gold. But all restrictions interfere with trade. A free market for gold is safer and in every way better than a protected one. It seems hard to believe that if the market is free, so that gold can be drawn away, we are likely to have more gold than we might have under the other system. Such, however is the case. People are more likely to leave their gold in a market from which they can get it on demand than they are in a market that makes difficulties about its withdrawal. This is one important difference between the London money market and that of any other part of the world. It is doubtful whether there will be any advantage in throwing restrictions about the withdrawal of specie from the proposed federated bank. That we are able to get gold when we want it goes without saying. We are a gold-producing country, and normally export gold, yet the figures show a very varied amount of exports and imports of specie.

According to the Department of Commerce and Labor, the total imports of gold ore, bullion, and coin from 1902–10 inclusive, was 707 millions, as against 623 millions exported. This shows that, speaking generally, we retained our home product and added to it by drawing from foreign countries. Yet, for the year ending June 30, 1910, according to the Director of the Mint, we imported gold in all forms to the amount of 43 millions, and exported it to the amount of 114 millions. These figures reveal the fact, well known to bankers, that gold is constantly on the move from or into the country. We get it as we get other things, by paying for it. We attract it as do the Bank of England and other foreign banks, by giving a higher rate of interest for it when we borrow it, or by selling our goods abroad at lower prices. Gold flows to the market where, all things considered, it earns most.

There is no good ground for the popular theory that we shall lose our gold. Gold will reach the bank first by the deposit by customers of checks from the assay offices in return for ore and bullion there deposited, and second from importation when we need it. As indicated before, there will be no difficulty in getting it. Our

own gold production has been running upward of 90 millions of dollars a year since 1906. What we want of this, the Reserve Association can keep by offering its owners a higher rate of payment for its use than they can get elsewhere. The bank will do this if the demand for discounts to create deposits and issue notes on the part of its customers justifies it in exacting of them in turn a sufficiently high rate. Similarly, we can get gold from other money centers by pledging or selling our securities and other goods, especially the products of our fields and manufactories.

It is important that a bank which is to control the specie reserve of the country should be able to command gold when it needs it and let it go when it does not need it, by having the power to vary the rate of discount as occasion requires. Our Reserve Association should be able to vary its rate of discount according to the state of the money market.

It is impossible to say beforehand what constitutes a proper ratio of specie reserve. Only experience is a safe guide for determining such a ratio. The proportion cannot be determined by the mere volume of liabilities. The character of the liabilities is important in this connection. The amount necessary is different according as the liabilities are demand liabilities or time liabilities; according as payments by the bank are largely payments of one customer to another; according to the state of internal trade, the condition of the foreign exchanges, variations in the volume of exports, and a variety of other considerations.

To the speaker, therefore, it appears that we shall do well to adopt the general plan of a national reserve association which shall keep the specie reserve of the country, instead of continuing our half-hearted system of many reserves, or changing that system into its extreme form. The amount of specie reserve to be held against deposits should not be fixed by law, but should be left to the judgment of the managers. A minimum might well be kept against notes. The managers should be in part government administrative officers, or under the supervision of such officers. With proper management and with conditions which will insure that the reserve association shall do a commercial and not a financial business; that it shall be a bank for the purpose of managing the currency of the country and not for promoting the interest of magnates,

there will be no difficulty in getting and maintaining at all times a reserve of gold sufficient for the business of the country.

These are the main principles which, in my opinion, should govern the management of the specie reserve in a scientifically constituted banking system. When we attempt to apply them to the conditions of our own country, they must be modified in at least one particular. We have a large volume of what is called lawful money. There is no good reason why this should not be used as part of the reserve of a reserve association. So far as concerns the redemption of domestic obligations, whether deposits or notes of the reserve association, it will answer every purpose. Of course, part of the reserve kept by a federated or central reserve bank must be in gold. What proportion of gold should be kept by our proposed association should be left, in my opinion, to the judgment of the managers.

This whole argument for a one-specie-reserve system presupposes an institution organized for commercial business only and not for financial promotion. Its discounts, whether for deposit or for note issue, should be based on commercial paper exclusively or mainly. It is true that there are some other assets nearly as liquid as commercial paper, but they are not many. Discounts on other kinds of collateral therefore should be extremely limited. What the country needs is banking that will regulate the currency, and not provide new facilities for speculative bankers and stock gamblers. Any plan we adopt must shut them out from all chance of twisting it to their purposes.

There is reason to believe that with our higher banking standards; with an aroused public opinion; with an increasing volume of foreign trade; with a separation of our financial from our currency interests; we can establish an institution which will relieve us from the frequent panics that have distressed us in the past thirty years and which will give us a more commanding position in the trade of the world, while at the same time assuring us a currency as universally acceptable as our present national bank note, with the added advantages of elasticity and adaptability to our needs.

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